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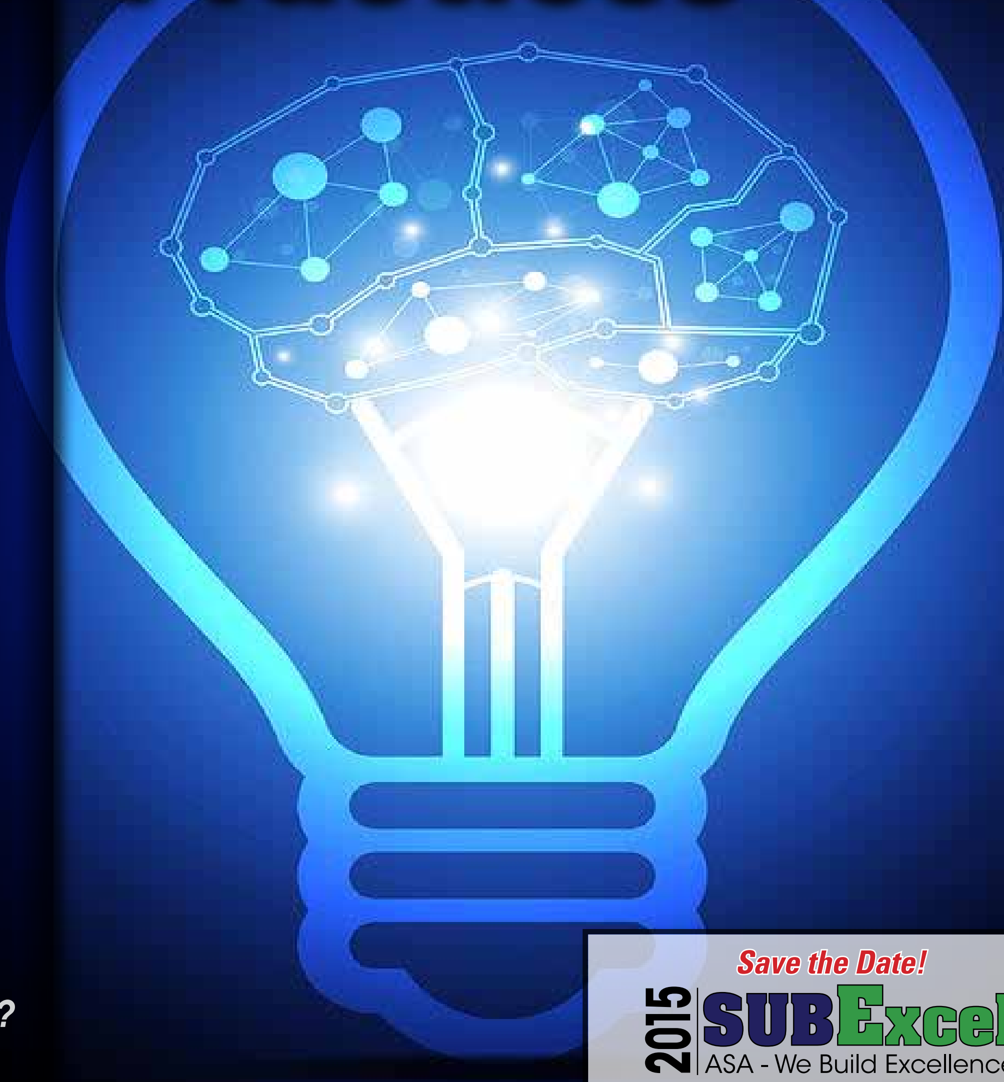
Best Practices



FEATURE

Credit Policy Best Practices

by Scott Wolfe

> ***"While it may hurt to turn down a sale if the results of the credit application is not sufficient to meet your policy guidelines, the actual cost of a non-paying client is much higher than the amount of the lost sale."***

Whether a business has a full-fledged credit department, a credit manager with a couple of employees, or utilizes another method of determining the parties which credit is extended, decisions are typically dependent on the size and organizational structure of the business, as well as the volume of credit decisions that must be made. No matter who is making these decisions, however, the decisions should be made in compliance with a structured credit policy.

Since credit decisions are vital to a business's ability to function smoothly, and directly impact the bottom line, sticking to a well-formed and properly drafted credit policy is of great importance. The best credit policies are well-structured, comprehensive and followed with strict compliance.

Mission Statement & Credit Goals

It's easy to write off a mission statement as a piece of boilerplate that no one even reads, let alone something to which anybody pays much attention. When properly drafted, though, a well thought out mission statement can provide a solid backbone for the credit department and can provide guidance on how the department should treat various situations.

A credit department mission statement should take the company's unique market position and overall goals into consideration, further reflecting the mindset of the company. For example, if the company has aggressive growth goals, the mission statement for that company will be necessarily different than that of a company with more modest growth goals. Keeping the mission statement internally focused is also beneficial, as a statement drafted from outside a company-specific viewpoint can end up being more distracting than beneficial.

Once a credit department has a solid foundation in a well-crafted mission statement, specific goals must be set to support and achieve the mission. These goals should be precise and tailored to support the mission statement.

To this end, the goals should be distinct, definite, measurable and concrete. The mission statement takes care of theory and strategy. The goals should be used as a defined path to reach the end result that the credit department wants. If the goals are met, the credit department should end up where it wants to be. If the goals are well-defined they can provide a step-by-step approach to getting the credit department tailored to perform as needed by the company. Choosing goals poorly can be enormously detrimental, reaching the wrong goals doesn't put the credit department any further along the desired path than not reaching the correct goals.

When drafting a set of credit goals, it is important to make them realistic and achievable — everybody wants 0 percent uncollectable accounts and no bad debt write-offs, but can it be accomplished? The credit department goals will define how the credit department works, and how it is structured, so it is important to take time to really focus on what the credit department needs to accomplish.

Organizational Tiers

Just like with every other department in the company, the credit department's structure must be defined. This includes both the structure of the department itself, in terms of who has the ultimate control — chief financial officer, vice president of finance, vice president of sales — as well as setting up a decision-making structure.

The usefulness and applicability of this section is directly tied to the size of

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- ***The best credit policies are well-structured and followed with strict compliance.***
- ***A credit department mission statement should consider the company's goals.***
- ***Credit evaluation is central to the function of the credit department.***

the company as a whole. If a company is small enough that the business owner takes on every credit decision, creating departmental organizational tiers is probably only useful in theory, if at all. However, it never hurts to have a plan in place for if or when the business expands, or when the owner wants to delegate some duties.

For larger companies, appropriate departmental structure is essential. Reviewing credit determinations is time-consuming and can result in significant backlogs. Multiple decision-makers are necessary for the department to remain streamlined and efficient. The trick, however, is to make sure that this does not lead to a credit department being consumed by the minutiae of an overwrought process. The organization of the credit department should be easily understood and not be so elaborate that it slows down the process they are attempting to streamline.

Determining which party will exercise final control over the department is crucial and has a profound effect on the department. A credit department that ultimately answers to sales — a bad idea in general — will behave in a much different manner than a credit department that answers to the CFO.

Credit Evaluation of New Customers

Credit evaluation is central to the function of the credit department. Minimizing credit risk/exposure, protecting margins and maximizing profits all stems from a good evaluation of the potential customer's credit. Much this work is accomplished through a thorough credit application.

A well-organized credit department should standardize the credit process. The first step in managing credit wisely is to make informed decisions about which parties should qualify, how much credit they should be extended and the terms thereof. Depending on the information in the credit application, the payment terms may be modified by either relaxing some policies or making them stricter. Some customers may not qualify for credit at all, and while it may hurt to turn down a sale if the results of the credit application is not sufficient to meet your policy guidelines, the actual cost of a non-paying client is much higher than the amount of the lost sale.

It is also a good idea for some businesses to include general terms of payment and/or the terms under which credit will be extended on the application itself. This provides clear receipt of the terms by the customer and requires the customer to agree to your payment terms and credit conditions as a prerequisite to applying for credit. However, it is important to consider that if the terms are included on the application, any potential modification to the general payment terms would then need an additional signed document.

Further, the credit application can be a good place to gain security on extensions of credit. Including a personal guarantee or security interest as part of the credit application proceeding can be a time-saver, but this should be done on a case-by-case basis.

Once the credit worthiness of the customer has been determined on a general scale, each individual customer must be provided a specific set credit limit. There are many factors to consider, but some will likely be the business credit score and the company value. From these pieces of information, a potential credit customer may be placed in a chart of credit worthiness, and the exact credit limit may be fine tuned from there. This type of process can be beneficial for a couple of reasons: 1) it allows the process to be streamlined and frees up employee time; and 2) pre-set basic credit limits decrease potential error and minimize risk.

Security & Risk Mitigation

Security should be obtained wherever possible to drastically reduce bad debt. For companies in the construction industry, security is built directly into the law in the form of the ability to file mechanic's liens to secure payment.

Sending all required preliminary notices, in order to make sure that no potential lien rights are lost, is the most important part of any lien and notice policy. Despite the complexities of compliance, it is imperative that sending proper notices is an integral part of a company's mechanic's lien policy. Failure to do so can extinguish mechanic's lien rights.

After the notice policy has protected lien rights, the lien policy must set forth the specific characteristics of the projects on which a lien will be filed. Since mechanic's liens secure the funds due via the property itself, mechanic's liens are a highly effective tool for getting paid. The key to do so without ruffling too many feathers is to create credit terms that allow mechanic's liens to be filed within the appropriate time period, without risking the expiration of the lien period and the extinguishment of lien rights. The decision to outsource mechanic's lien compliance or to keep it in-house is a company-by-company decision that can depend on many factors.

Also, other forms of security can be obtained, such as UCC security interests and personal guarantees.

Collections & Litigation

The final steps in a thorough credit policy are the collections policy and litigation policy. Depending on the size of the business, the same in-house or outsource questions confronted in the security and risk mitigation section are relevant here. Generally, it is a better use of resources to eventually outsource, that is, after a reminder phone call and letters have been taken care of in-house. The greater the security for the extension of credit, the easier it will be to collect — either through collections or via lawsuit.

A well-drafted and routinely utilized credit policy is the best way to streamline a credit department and reinvent A/R.

Scott Wolfe is CEO of zlien in New Orleans, La., a platform that reduces credit risk and default receivables for contractors and suppliers by giving them control over mechanic's lien and bond claim compliance. Wolfe is a licensed attorney in six states with extensive experience in corporate credit management and collections law, including the use of mechanic's liens, UCC filings and other security instruments to protect and manage receivables. He can be reached at (866) 720-5436, Ext. 700, or scott@zlien.com, or @scottwolfejr on Twitter.